No. 16,201

In the United States Court of Appeals for the Ninth Circuit

BANKLINE OIL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 19-44) are reported at 30 T. C. 475.

JURISDICTION

This petition for review (R. 46-54) involves federal income taxes for the taxable year 1952. On October 25, 1955, the Commissioner of Internal Revenue mailed to the taxpayer notice of a deficiency in the total amount of $14,342.52. (R. 11-16.) Within ninety days thereafter and on January 16, 1956, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 3-10.) The decision of the Tax Court was entered June 5, 1958. (R. 45.) The case is brought to this Court by petition for review filed August 22, 1958. (R. 46-54.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Was the Tax Court correct in holding that the processing contract of November 1, 1952, was merely an agreement whereby taxpayer employed Signal Oil and Gas Company to process wet gas and that, as agreed compensation for being awarded a contract for processing wet gas at the favorable fees provided, Signal paid taxpayer the sum of $85,000, which was taxable as ordinary income, and not capital gain as taxpayer contends.

2. Was the Tax Court correct in holding that the sum of $11,351.41, received by taxpayer in 1952 as the net proceeds of the processing operations carried on during that year, represented merely its net profit from the sale of processed gas, and hence was taxable as ordinary income, not capital gain as the taxpayer contends.

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) [As amended by Sec. 1, Public Salary Tax Act of 1939, c. 59, 52 Stat. 574] *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) [As amended by Sec. 210(a), Revenue Act of 1950, c. 994, 64 Stat. 906] *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or real property used in his trade or business;

* * * *

(4) [as amended by Sec. 150(a)(1), Revenue Act of 1942, c. 619, 56 Stat. 619, and by Sec. 322(c)(2), Revenue Act of 1951, c. 521, 65 Stat. 452] *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;

* * * *

(b) [as amended by Sec. 322(a)(2), Revenue Act of 1951, *supra*] *Deduction from Gross Income.*—In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 per centum of the amount of such excess shall be a deduction from gross income. * * *

* * * *

(26 U. S. C. 1952 ed., Sec. 117.)

STATEMENT

The facts as found by the Tax Court (R. 20-36), some of which were stipulated (R. 55-63), may be briefly summarized as follows:

Taxpayer is a California corporation with its principal office in Los Angeles, California. During the years here involved it kept its books and filed its income tax returns on an accrual basis. The taxpayer's business consists of the processing of casinghead gas, or wet gas, derived from the production of petroleum oils into its separate ingredients, namely, natural gasoline, dry gas and propane gas, as well as the operation of a refinery where natural gasoline is blended with other gasoline and after being refined is sold to the public through retail outlets. Taxpayer's refinery is located at Bakersfield, California, and during 1952, and previous years it had processing plants in Santa Fe, Maricopa Springs, and Signal Hill, California. The availability of a supply of gas sufficient to enable a processing plant to operate as nearly as possible to full capacity is an important factor in determining whether operation of such a processing plant may be profitable. (R. 21.)

More than six months prior to November 1, 1952, taxpayer had entered into eight contracts with oil producers for the acquisition by it of casinghead gas produced from drilling operations in the Signal Hill Field. Each of the contracts provided that taxpayer was to install and maintain pipelines from the producers' wells or gas traps to its Signal Hill processing plant; that taxpayer was to install meters on the pipelines in order to keep an accurate account of the gas emanating from the wells of the several producers who agreed to deliver the gas at the pipeline and that taxpayer was to process the gas and pay each producer a stated percentage of the proceeds derived from taxpayer's sale or use of natural gasoline and propane gas extracted by the processing. If a producer so desired, he could elect to receive payment in kind. Upon completion of processing taxpayer had the right to sell all of the product not required to be returned to the producer in kind and to pay a fixed percentage of the sale price received. (R. 22.)

Taxpayer had the right to, and did, use natural gasoline extracted by its processing for its refinery and paid the producer a royalty based upon the market price of such gasoline. The natural gasoline used by taxpayer in its refinery was not the same gasoline which resulted from its processing operation at Signal Hill. It obtained the gasoline at its Bakersfield refinery from Standard Oil Company of California through an exchange agreement by virtue of which taxpayer eliminated the cost of transporting gasoline from its processing plant at Signal Hill to the refinery. (R. 22.)

The Signal Oil and Gas Company (hereinafter referred to as Signal), also owned and operated a casinghead gas processing plant at Signal Hill. During the fall of 1952, because of an inadequate source of supply of gas, taxpayer determined that the operation of its processing plant at Signal Hill was unprofitable or likely to become so, and, therefore, sought a profitable method of disposing of its processing plant and equipment. Accordingly, it commenced negotiations with Signal for the sale of its processing plant to the latter. On November 1, 1952, taxpayer sold to Signal its processing plant, pipelines, pipes, meters and fittings at Signal Hill (except the pipelines, pipes, meters and fittings located on properties from which wet gas was being delivered under the contracts with the producers) together with certain oil leases, interest in lands and gasoline storage and pier facilities in Santa Barbara, California. (R. 23.)

On November 1, 1952, taxpayer and Signal also entered into a separate agreement which was effected by taxpayer's acceptance on that date of an offer of Signal contained in a letter addressed to taxpayer dated October 29, 1952. (R. 23.) This agreement provided in pertinent part as follows (R. 23-26):

> Subject to the conditions and for the considerations hereafter set forth, Signal Oil and Gas Company hereby offers to purchase from you the following properties, to wit:
>
> All leases, gas contracts or other purchase agreements held by Bankline for the purchase or processing of wet gas from properties located in the Signal Hill Oil Field. A schedule of said instruments is hereunto attached and by this reference made a part hereof and marked Exhibit "A".
>
> Signal Oil and Gas Company offers to pay for the above-described properties the sum of $85,000.00, plus further sums of money calculated in the following manner:
>
> Signal shall process said wet gas, or cause said wet gas to be processed, at its plant in the Signal Hill Oil Field or at such other plant or plants as Signal shall hereafter elect, whether or not said plants shall be owned and/or operated by Signal. All dry gas resulting from said operations not required to be returned to the properties from which produced shall be sold by Signal and the net sales price paid to Bankline monthly.

All natural gasoline and LPG Propane extracted by Signal from said wet gas shall likewise be sold by Signal at the average price it receives for like products sold by Signal, and Signal shall pay Bankline monthly a sum of money equal to the sales price of said natural gasoline and LPG Propane, less the following sums, to wit:

> The sum of 2½c per gallon on all natural gasoline and the sum of 1¼c per gallon on all LPG Propane.

Said deductions are based upon the present price of 8.33c per gallon posted by Standard Oil Company of California for 21# R.V.P. natural gasoline in the Signal Hill Oil Field and shall be increased or decreased at the times and in direct proportion to any increase or decrease above or below said price of 8.33c per gallon posted by Standard Oil Company of California for 21# R.V.P. natural gasoline in the Signal Hill Oil Field.

* * * *

This agreement shall remain in full force and effect for the period of ten years from November 1, 1952, and thereafter so long as Signal shall elect. In the event that at any time after ten years from November 1, 1952, Signal shall desire not to receive and/or process the wet gas produced from the properties described in Exhibit "A" it shall give written notice to that effect to Bankline. Within thirty days after said notice Bankline by written notice to Signal may elect to purchase the leases, gas contracts and other purchase agreements herein purchased from Bankline for the sum of $10.00 and have such of said leases and other agreements then remaining in effect reassigned to it, and upon

> notice to that effect Signal shall reassign all of said leases and agreements. In the event Bankline shall not elect to receive such reassignments, then Signal may without further obligation to Bankline sell or assign said agreements to third parties or may quitclaim, surrender or otherwise terminate any or all of them.

* * * *

The contracts described in Exhibit A as referred to in the foregoing agreement were the eight contracts with the producers. (R. 27.)

Pursuant to the above agreement taxpayer, on November 1, 1952, executed an "Assignment" which stated that taxpayer assigned to Signal "all its right, title and interest in, to and under" the eight contracts with the producers previously mentioned. Payment of the $85,000 provided for in the agreement of November 1, 1952, was effected by Signal's execution of a note in that amount, without interest, dated December 1, 1952, which provided for the payment of $4,000 monthly for twenty months and a payment of $5,000 in the succeeding month. This note was paid in accordance with its terms. (R. 27.)

On November 1, 1952, taxpayer and Signal entered into an oral agreement which was reduced to writing on December 1, 1952, in a letter from Signal to taxpayer of that date. (R. 27.) That agreement provided as follows (R. 27-28):

> Reference is made to our letter to you dated October 29, 1952, wherein Signal Oil and Gas Company offered to purchase from you certain leases, gas contracts and other purchase agreements held by Bankline for the purchase or pro-

cessing of wet gas from properties located in the Signal Hill Oil Field, which offer was accepted by you under date of the day of November, 1952.

Signal Oil and Gas Company hereby agrees to sell and deliver to you natural gasoline in monthly amounts equivalent to the amount of natural gasoline extracted by Signal from the wet gas processed by it under the provisions of the above-mentioned letter agreement of October 29, 1952. The term of this agreement shall be ten years from November 1, 1952, and so long thereafter as Signal shall be receiving wet gas produced from the above-mentioned wells.

The sales price of all natural gasoline delivered pursuant to this agreement shall be the average price received by Signal during the month in which deliveries are made for natural gasoline of like quality sold by Signal in the Signal Hill Oil Field.

* * * *

During the negotiations leading to the agreements mentioned Signal decided, for accounting and tax purposes, that its total payment of $135,000 be divided and allocated to the various contracts referred to. Accordingly, $85,000 was allocated to the casing-head gas contracts, $25,000 for the processing plant and equipment and $25,000 for other assets of taxpayer, but as far as either party was concerned the transaction was a "package deal". At first taxpayer was indifferent to the matter of allocation but later it became concerned that the amount allocated to the processing contract might be determined to constitute ordinary income. (R. 28-29.) This concern was communicated to Signal and as a result the latter, by letter dated December 1, 1952 (R. 29), agreed—

> to indemnify and hold Bankline Oil Company harmless from the payment of any greater United States corporate income tax pursuant to Sections 13, 15 and 430 of the Internal Revenue Code on the receipt of said sum of $85,000.00 than the said income tax calculated on said sales price pursuant to Section 117 of said Code.

Signal dismantled the processing plant which it acquired from taxpayer but connected its main pipeline to taxpayer's line and thus took the wet gas formerly processed by taxpayer to its own plant at Signal Hill. Signal installed a meter on this main pipeline and thereafter accounted to taxpayer for the total gas received. Taxpayer continued to own and maintain the pipelines to the producers' wells and the meters used in connection therewith and made regular meter readings of the gas received from each producer. Taxpayer also remained liable to the producers for the payment or delivery of royalties on the gas obtained from them; taxpayer, therefore, continued to maintain its own royalty records and to compute and pay the royalties due. (R. 29.)

Taxpayer's operations with Signal were generally carried on as follows: All natural gasoline produced by Signal under the contracts with the producers was delivered to Standard Oil Company of California for the account of taxpayer pursuant to an exchange agreement. By direction of taxpayer part of this gasoline was delivered to one of the producers by Standard Oil Company to satisfy taxpayer's obligation to deliver a royalty in kind under the contract with that producer. Standard Oil then delivered a quantity of natural gasoline equal to the balance remaining to taxpayer at its Bakersfield refinery pursuant to the exchange agreement between taxpayer and Standard Oil Company. (R. 30.)

Signal billed taxpayer for the entire amount of natural gasoline produced from the wet gas processed under the producers' contracts and the amount billed was paid to Signal by taxpayer. Signal thereupon deducted its charge of 2½ cents per gallon from taxpayer's payment and returned the amount remaining to taxpayer. The liquid propane gas produced from the wet gas processed under the producers' contracts was sold to third parties by Signal which received the total sales price. Signal thereupon deducted its charge of 1¼ cents per gallon and remitted the balance to taxpayer. (R. 30.)

With respect to the dry gas, a portion of such gas was returned to the leases as required by the contracts with the producers. If the amount of gas returned exceeded the amounts required under such contracts taxpayer billed the producers directly for such excess and received payment therefor. A portion of such dry gas was also delivered to one of the producers by Signal in order to satisfy taxpayer's obligations to deliver dry gas as a royalty in kind under the contract with that producer. The remainder of the dry gas was sold by Signal to third parties and the entire proceeds were remitted to taxpayer without deduction; there was no charge for processing dry gas. (R. 31.)

Although in the fall of 1952 Signal was not using its total capacity, it was operating its Signal Hill processing plant with an adequate supply of casinghead gas. The processing of the additional gas obtained through taxpayer's contracts with producers would cause only a slight increase in the cost of operation. The gas obtained from taxpayer was unusually rich in that it produced between eight and nine gallons of natural gasoline per 1,000 cubic feet of gas~~oline~~. The royalties due under taxpayer's eight contracts averaged about 42 percent of the value of the natural gasoline and propane gas produced from wet gas. The going rate of such royalties in 1952 in the Signal Hill area was about 55 percent. Signal believed that the production of casinghead gas in this field would remain relatively constant for a number of years. (R. 31-32.)

In 1952, the usual charge in the Signal Hill Oil Field for processing wet gas varied between $.0075 and $.0085 per gallon of natural gasoline. At that time a contract to process wet gas in this area was ordinarily characterized by an agreement to extract natural gasoline, propane and dry gas for a fixed price per gallon of gasoline produced. Under such contracts, the extracted products were returned to the owner of the wet gas and no title to such gas was transferred to the processor. Such contracts also normally provided for termination on relatively short notice and it was not customary to pay the processor a bonus for his services. (R. 32.)

On its books Signal treated the November 1, 1952, transaction relating to the eight producers' contracts as constituting the acquisition of a capital asset and has amortized the amount of $85,000 as the cost thereof. Taxpayer, on the other hand, on its books has treated the same transaction and Signal's subsequent disposition of the products produced as sales of those products and the amounts retained by Signal as the latter's charges for processing. (R. 32.) The oral agreement which was reduced to writing on December 1, 1952, concerning the charge by Signal to taxpayer of the natural gasoline produced from the wet gas under the producers' contracts was cancelled by the parties on October 9, 1957, effective October 1, 1957. (R. 32-33.)

The taxpayer was not engaged in the business of buying and selling casinghead gas contracts. It had no cost or other basis in the eight producers' contracts involved herein. (R. 33.)

The following is a statement computed on an accrual basis showing the results of Signal's and taxpayer's operations for the months of November and December, 1952, and the years 1953, 1954, and 1955, with respect to the eight producers' contracts involved herein. (R. 34):

	1952	1953	1954	1955
Total value of natural gasoline produced by Signal	$30,557.27	$243,189.78	$231,449.15	$228,378.35
Total amount of propane gas sold third parties by Signal	666.73	5,529.09	5,401.10	4,814.48
Total amount received by Signal from sale of dry gas not consumed by oil and gas producers nor by Signal	1,817.14	13,997.25	13,869.17	16,229.30
Total amount of dry gas delivered by Signal as royalty in kind for account of petitioner	942.66	7,201.64	7,129.82	8,226.81
Total amount of dry gas returned to leases in excess of amounts required by leases	57.57	275.55	229.26	227.47
Total	34,041.37	270,175.31	258,078.50	257.876.41
Portion of sales price of natural gasoline and propane gas retained by Signal	10,235.87	79,196.89	75,026.84	74,772.56
Amounts remitted by Signal to petitioner	23,805.50	190,978.42	183,051.66	183,103.85
Royalties paid by petitioner (plus fair market value of natural gasoline and dry gas delivered in kind)	12,454.09	96,488.68	92,048.81	92,638.42
Net amount remaining after petitioner's payment of royalties to producers	11,351.41	94,489.74	91,002.85	90,465.43

In Schedule D of its income tax return for 1952, taxpayer reported a long-term capital gain of $94,-440.84. In an accompanying explanatory schedule taxpayer referred to the sale of four automobiles, two parcels of real estate and some casing on August 31, 1952, and previously during that year. This schedule also referred to a sale on November 1, 1952, of "Signal Hill Absorption plant, State Lease PRC 421, and Bishop Tank farm." The sale price for this item was shown as a single amount of $135,000. Likewise shown in single amounts were depreciation, $973,441.76, cost, $1,013,664.67, and gain, $94,777.09. Concededly, taxpayer's schedule contained nothing to indicate that any of the eight producers' contracts had been sold or that any part of the sales price of $135,-000 had been received for or with respect to any of such contracts. (R. 35.) After a field investigation of taxpayer's liability for 1952, the Commissioner determined that $85,000 of the $94,777.09 reported by taxpayer as long-term capital gain from the sale of the absorption plan, the state leases and the tank farm constituted ordinary income. (R. 35.) In its notice of deficiency the Commissioner gave the following explanation (R. 35-36):

> You reported as long-term capital gain the sum of $85,000 received during the taxable year from Signal Oil and Gas Company under the terms of an agreement dated November 1, 1952, providing for the processing by that corporation of wet gas from certain properties located in the Signal Oil Field District which are covered by your previous agreements with the producers.

> It is held that the sum of $85,000 received in the taxable year constitutes ordinary taxable income under the provisions of section 22 of the Internal Revenue Code of 1939 instead of long-term capital gain as reported on your return.

Under taxpayer's processing arrangement with Signal concerning wet gas obtained from the producers' contract there accrued to taxpayer for the months of November and December, 1952, total income in the sum of $11,351.41. This amount was reported by taxpayer as ordinary income in its tax return for the year 1952 and like income accruing in subsequent years has been similarly reported as ordinary income in the returns for those years. (R. 36.)

The Tax Court overruled taxpayer's assertions that the agreement of November 1, 1952, constituted a sale by taxpayer of its interest in the eight contracts with the oil producers. After reviewing the contract, the operations thereunder and the conduct of the parties with respect thereto, the Tax Court concluded that the substance of the transaction of November 1, 1952, constituted nothing more than an arrangement whereby taxpayer employed Signal for a period of ten years at a fixed or determinable compensation to perform a portion of the work which taxpayer was required to perform under its contracts with the producers. The amount received, $85,000, was a payment by Signal to taxpayer for being engaged to render services for taxpayer. Such an amount does not represent the proceeds of the sale of a capital asset but constitutes ordinary income taxable as such. Similarly, the amount of $11,351.41 received by taxpayer in 1952 also represented proceeds from the employment contract awarded to Signal and constituted ordinary income. Since both of the amounts in controversy represented ordinary income taxable as such, the Tax Court sustained the deficiency asserted by the Commissioner. (R. 36-44.)

SUMMARY OF ARGUMENT

Taxpayer had contracts with eight oil and gas producers in the Signal Hill Field under which taxpayer was entitled, in substance, to the output of wet gas from the producers' wells, subject to the payment of stipulated royalties in the form of a percentage of the natural gasoline, liquid propane and dry gas which taxpayer processed from the wet gas received. By agreement of November 1, 1952, Signal Oil and Gas Company agreed to process the wet gas received by taxpayer, to deduct specified charges and to remit the remaining proceeds to taxpayer. In the Tax Court, and to some extent here, taxpayer contended that this transaction constituted a sale of its eight producers' contracts and that the consideration it received, $85,000, was entitled to capital gains treatment. The Tax Court disagreed with taxpayer's views and held that the contract was nothing more than an employment agreement under which Signal agreed to process the wet gas for the charges specified and that the sum of $85,000 which taxpayer received from Signal, the stated consideration for the transaction, represented compensation to taxpayer for the reduced amounts it would receive by reason of the favorable processing charges to which Signal was entitled.

The basic question presented on this appeal, therefore, is whether the contract of November 1, 1952, for the processing of wet gas constituted a sale or exchange of a capital asset. In resolving this question we may put aside as irrelevant contentions that taxpayer was a manufacturer and that the producers' contracts constituted capital assets, for they are not dispositive of the issue as to whether any sale occurred. Taxpayer claims capital gains treatment on two items, the $85,000 it received as the consideration for the agreement, and the sum of $11,351.41, the amount realized by it during the two months of 1952 in which the contract was in operation. The items will be considered in the order stated.

I. The decision of the Tax Court that the transaction of November 1, 1952, constituted an employment arrangement, not a sale, was based on detailed findings of fact which may not be set aside unless clearly erroneous. Taxpayer, in fact, does not refer to any evidence which tends to contradict those findings, but apparently prefers to rely on the transaction itself. The circumstances of the contract quickly demonstrate that the Tax Court's appraisal of it as a mere employment arrangement was clearly correct, for here there was no transfer of rights or property as is ordinarily encompassed by a genuine sales transaction. The only right which Signal acquired under the agreement in question was the right to perform services for taxpayer at a specified fee. Nothing more was transferred to Signal, however, nor did Signal acquire any of taxpayer's rights against or obligations to the producers.

The fact that the agreement purports to recite a purchase of the producers' contracts is immaterial, for we are not bound by mere labels, and the agreement itself demonstrates that no sale was intended. Signal was in no sense of the word substituted for taxpayer in its relation to the producers. Signal merely agreed to take the wet gas from taxpayer's lines, process it, deduct the charges specified and remit the proceeds remaining to taxpayer. Although a sale of the producers' contracts is claimed, we find that taxpayer remained liable for the payment of royalties to the producers and that Signal did not even purport to assume any of the contract obligations to the producers. Enlightening also are the provisions of the agreement concerning termination after ten years, wherein it is specified that if Signal wishes to terminate, taxpayer may "purchase" the producers' contracts for $10. These provisions serve to demonstrate that it was the intent of the parties that Signal should not realize any income from the contract in question, apart from its processing charges.

The parties conducted themselves in accordance with the contract, but by a supplemental oral agreement of November 1, 1952, attempted to make it appear that Signal had in reality purchased the producers' contracts. Under that oral agreement taxpayer agreed to purchase all the natural gasoline produced by Signal from the wet gas taken from taxpayer. Although taxpayer paid for the gasoline as provided in the oral agreement, Signal, upon receipt of the payment, merely deducted its processing charge and remitted the balance to taxpayer. In effect, Signal merely processed the gasoline for taxpayer's account, a fact confirmed by the testimony of taxpayer's president. This fact is also confirmed by taxpayer's books and tax return for 1952 in which the sales proceeds of the processed gas were treated as sales of taxpayer's own products.

It is apparent, therefore, that the contract in question was in fact, as the Tax Court held, an employment agreement and that the payment received by taxpayer was the compensation paid for enabling Signal to realize the highly favorable processing charges provided therein. Such processing charges were three timees the normal charges paid for such processing. Though realizing that the transaction amounted to a mere employment, taxpayer and Signal attempted to make it appear as a sales transaction; fearing that the measures taken might not be sufficient, taxpayer demanded and received an indemnity agreement from Signal under which it was saved harmless from the payment of taxes on the transaction at more than capital gains rates. The parties thus demonstrated that the transaction was hardly a sale in form, much less in substance.

In its brief in this Court, taxpayer, for the first time, appears to argue alternatively that the transaction was a sale of a thirty percent interest in its producers' contracts for \$85,000. This alternative argument concedes that the remaining sum of \$11,-351.41 could not be capital gain on that theory. The argument rests on the fact that Signal's agreed processing charge of 2½ cents per gallon for natural gasoline was premised upon a gasoline price of 8.33 cents per gallon and was thirty percent of that amount. Taxpayer should not be heard now to present a new argument not presented to the court below and not contained in his statement of points filed with this Court.

In any event, it is obvious that such argument is a mere afterthought created in an effort to salvage some relief from the adverse decision below. The argument contradicts taxpayer's main argument that the entire producers' contracts were sold and there is no evidence in the record to support it. Neither taxpayer's books nor its tax returns support such a theory, for the former do not refer to any fractional interest, or any sale at all, but merely treat the products as still belonging to taxpayer, and the latter do not even refer to the contract in question. The argument is not even supported by simple arithmetic, for a comparison of processing charges and gasoline prices demonstrates that in November and December, 1952, the charges were almost 32 percent of the gasoline prices; taxpayer would hardly contend that it sold a fluctuating percentage interest. On this theory, as on taxpayer's first argument, it must be concluded that taxpayer, after the transaction of November 1, 1952, had exactly the same basic rights as before, the right to the net proceeds of the processed gas. It surrendered only its processing operation, for which it employed Signal at a generous fee, and the sum of $85,000 received from Signal was paid as compensation for the favorable fees Signal was enabled to receive. It was thus taxable as ordinary income as the Tax Court properly held.

II. The foregoing arguments also serve to dispose of taxpayer's further contention that it was entitled to capital gains treatment on the sum of $11,351.41, the net proceeds retained by it from sales of processed gas in November and December, 1952. This is necessarily true, for if there was no sale of the producers' contracts, then the $11,351.41 could not form a part of any sales price for such contracts. On its alternative theory, discussed above, taxpayer concedes that it is not entitled to prevail on this item.

In its operations under the processing contract with Signal, taxpayer received what it had previously been entitled to receive, the net proceeds of processed gas, less only processing charges. The processed gas, until sold to third parties, remained taxpayer's property, and upon such sale, the resulting proceeds represented merely profit on the sale of stock in trade, since taxpayer was clearly in the business of selling processed gas. The profit on the sale of stock in trade is, of course, taxable as ordinary income. Since there was no sale of the producers' contracts, the Tax Court correctly held taxpayer not entitled to capital gains treatment on the sum of $11,351.41.

ARGUMENT

I

The Processing Contract of November 1, 1952, Did Not Involve the Sale or Exchange of a Capital Asset; the Sum of $85,000 Received By Taxpayer Thereunder Was Therefore Taxable As Ordinary Income As the Tax Court Held

The basic question presented on this appeal is whether the processing contract of November 1, 1952, involved the sale or exchange of a capital asset, by taxpayer to Signal. That contract in substance provided that Signal agreed to process all the wet gas which taxpayer was entitled to obtain from the oil producers under the eight contracts which it held and that Signal agreed to remit to the taxpayer the entire sales proceeds of the resulting products, retaining only specified processing charges. (R. 23-25.) Taxpayer contended below, and appears to contend here, that this transaction constituted a sale by it of the eight producers' contracts. The Commissioner, on the other hand, contended that the transaction in substance was nothing more than an employment arrangement pursuant to which Signal agreed to process the wet gas for taxpayer, sell the products for taxpayer's account and remit the entire proceeds to taxpayer, retaining only the specified charge for its processing services; the sum of $85,000, the consideration for the transaction, was merely compensation to taxpayer paid by Signal for the awarding of such contract at the favorable fees therein provided. The Tax Court agreed with these contentions and sustained the Commissioner's determination of a deficiency.

Taxpayer, in his brief (pp. 20-23), devotes considerable attention to arguing that it was a manufacturer of the products resulting from the wet gas and that the eight contracts with the producers for the supply of such wet gas constituted capital assets in its hands within the meaning of Section 117(a) of the 1939 Code, *supra*. We need not tarry to consider these arguments at any great length for they shed no light on the issue here presented for determination. That issue stated in its simplest form is: did taxpayer sell its eight producers' contracts to Signal in the transaction of November 1, 1952? In order to answer this question it is completely immaterial whether we call taxpayer a manufacturer or processor of wet gas or the products resulting therefrom or whether it was merely rendering services. Even if taxpayer was a manufacturer, this does not resolve the question as to whether it sold the producers' contracts. Likewise we need not pause to consider whether the producers' contracts may properly be classified as capital assets under the statute, for, if they were not sold, their status as capital assets *vel non* is completely irrelevant.

A. ***Taxpayer did not sell its producers' contracts to Signal***

The Tax Court has held that there was no sale of the eight producers' contracts to Signal on November 1, 1952, but that the transaction of that date constituted merely an arrangement whereby Signal agreed to perform services for taxpayer at specified rates. (R. 43.) These rates were very favorable to Signal, and consequently it paid taxpayer $85,000 for the privilege of performing the services, and at the same time compensated taxpayer for the reduced profits taxpayer would realize due to the abandonment of its own processing operation. (R. 43-44.) The decision of the Tax Court was based upon detailed findings of fact entered after a careful review of the evidence. It is those findings which taxpayer in reality is attacking when it contends that the transaction of November 1, 1952, constituted a sale of its contracts with the producers. This is necessarily true, because the Tax Court found that under the contract of November 1, 1952, Signal sold or delivered all of the natural gasoline, propane and dry gas for taxpayer's account and remitted to taxpayer the entire proceeds, deducting only the specified charges for processing natural gasoline and propane. (R. 30-31.) The Tax Court also found that taxpayer remained the owner of the pipelines leading to the producer's wells and continued to be liable to and to pay to the producers the royalties due under the contracts with them. (R. 29.)

These findings do not permit of any other conclusion than that there was no sale of the producers' contracts by taxpayer to Signal, for such facts are inconsistent with an absolute transfer of taxpayer's entire rights and obligations under the producers' contracts as in the case of a true sale. Since the determination of the Tax Court rests upon specific findings based upon a review of conflicting evidence, such findings may not be set aside unless clearly erroneous. Rule 52(a), Federal Rules of Civil Procedure; *United States* v. *Gypsum Co.*, 333 U. S. 364, rehearing denied, 333 U. S. 869. Indeed, taxpayer does not refer us to any evidence which even tends to contradict the findings of the Tax Court.

Decision of this case need not rest, however, on any technical considerations as to the reviewability of findings of fact, for the findings and conclusions of the Tax Court in this case are supported by such an abundance of evidence that a contrary conclusion would be contrary to plain reason. If we examine the relevant aspects of the purported sales transaction of November 1, 1952, together with the operations and conduct of the parties under that agreement, it becomes quickly apparent that what purported to be a sale was in reality nothing more than an employment agreement under which Signal agreed to perform services for taxpayer. A payment to compensate taxpayer for having awarded Signal the privilege of performing such services, at favorable rates is not a payment for the sale of a capital asset, and is thus not taxable as a long-term capital gain under the provisions of Section 117(a)(4) of the 1939 Code, *supra*, but is ordinary income under Section 22(a), *supra*, taxable as such. Under Section 117(a)(4), the word "sale" is to be given its ordinary meaning. *Helvering* v. *Flaccus Leather Co.*, 313 U. S. 247; *Hale* v. *Helvering*, 85 F. 2d 819 (C. A. D. C.). In its ordinary meaning, of course, a sale denotes an absolute transfer of rights for a consideration; it does not denote a transaction under which a consideration is paid but no rights are transferred other than the right to perform services. See *McFall* v. *Commissioner*, 34 B.T.A. 108.

In the transaction here in question the only thing transferred was the right to perform services for taxpayer at a specified fee. Signal acquired none of taxpayer's rights against, or obligations to, the oil producers. Yet that is all that taxpayer had to sell, for we start with the proposition, as the Tax Court noted, that taxpayer had no interest in the gas in place under the decision of the Supreme Court in *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362.[1]

Looking first at the contract of November 1, 1952, we find that the provisions of that contract themselves virtually supply the answer to the question in dispute. It is true that the contract at the outset purports to recite a purchase of the gas contracts. (R. 23-24, 182.) We are not bound by mere labels, however, and must look at the entire contract to determine the true nature of the transaction. *Hamme* v. *Commissioner*, 209 F. 2d 29 (C. A. 4th), certiorari denied, 347 U. S. 954. Under the contract Signal agreed to process the wet gas, to sell the natural gasoline, propane and dry gas resulting therefrom and to pay taxpayer the proceeds realized from such sales, deducting only 2½ cents per gallon of natural gasoline, and 1¼ cents per gallon on liquid propane. No deduction was provided for the proceeds derived from the sale of dry gas and such proceeds were to be remitted to taxpayer in full. This processing arrangement, the contract stated, was to continue for

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[1] That decision dealt with four of the producers' contracts here involved. It is not disputed that the remaining four contracts are substantially the same as those which were before the Supreme Court.

a period of ten years, after which Signal might terminate the arrangement at any time by written notice to taxpayer. In that event taxpayer had the right upon appropriate notice to "purchase" the gas contracts from Signal for the sum of $10. The contract also provided that Signal was to establish connections between its existing pipelines and those owned by taxpayer for the transmission of wet gas and was to install meters in order to enable it to account to taxpayer for the wet gas received at the connection points. (R. 23-26, 182-185.)

It is significant to note that under this contract taxpayer still stood between Signal and the oil producers. Signal did not have the right to take the wet gas directly from the producers' wells nor, in fact, did Signal have any direct dealings with the producers. Taxpayer continued to take the wet gas from the producers in its own pipelines, through its own meters, and to deliver it to Signal at agreed points. Significant, also, is the fact that although taxpayer was required to pay the producers a royalty averaging about 42 percent of the natural gasoline and propane (R. 31) nowhere does the contract state that Signal assumed taxpayer's obligation to make royalty payments or deliveries in kind as required by the producers' contracts. It is a strange sale of contract rights indeed where the seller remains liable under the contracts which it has purportedly sold, and the purchaser does not even purport to assume any of the obligations imposed by such contracts! Nor can we overlook the provisions for termination of the contract whereby, upon Signal's election to terminate after ten years, taxpayer may "purchase" for $10 the contracts purportedly sold. (R. 26, 184-185.) These are the same contracts which taxpayer would have us believe were originally sold to Signal in 1952 for $85,000.[2]

The significance of these termination provisions is clear. They complete the contract chain which prevents Signal from realizing any income under the contract of November 1, 1952, beyond its processing charge of 2½ cents per gallon for natural gasoline and 1¼ cents per gallon for liquid propane. Not only must Signal remit to taxpayer every penny of the proceeds of these products over and above these charges and the entire proceeds of dry gas sales, but it is not even afforded the opportunity of realizing additional income by reselling the producers' contracts, which it has purportedly purchased, to third parties at the prevailing market price. Signal, under the terms of the contract, is not merely required to give taxpayer a right of first refusal, but a right of first refusal at $10. The effect of all these contract provisions is to make it crystal clear that no

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[2] Taxpayer attempts to explain this provision by asserting (Br. 27), "It may be reasonably inferred from the assignment contract that the wet gas would be completely depleted within ten years". This is sheer speculation, however, and is contradicted by the findings of the Tax Court which include, among other things, a finding that Signal believed the production of casinghead gas in this field would remain relatively constant for a number of years. (R. 32.) In fact Signal's president, Mr. Green, testified that Signal Hill was a "very long-life field" and that "The wells, we figured, would last a considerable length of time." (R. 236.)

producers' contracts were in truth and in fact sold to Signal by taxpayer, but, on the contrary, that taxpayer merely employed Signal to process the wet gas because it had sold its own processing plant.

An examination of the conduct of the parties does not lead to any different result. Signal sold the products, deducted the charges specified in the contract of November 1, 1952, and remitted the entire remaining proceeds to taxpayer. (R. 30-31; Exs. 8-A, R. 205-209.) Taxpayer paid the royalties due under the producers' contracts from these proceeds and retained the balance for its own account. Moreover, the actions of the parties with respect to natural gasoline demonstrate beyond question that they fully realized that the transaction too closely resembled an employment of Signal by taxpayer and that they therefore determined to attempt to give the appearance of a genuine sale to the transaction. This was done by the oral agreement of November 1, 1952, (reduced to writing on December 1, 1952), under which taxpayer agreed to purchase all of the natural gasoline produced by Signal from the wet gas taken from taxpayer's lines. (R. 27-28, 203-204.) This agreement might have had some significance, if it were not for the subsequent conduct of the parties and the provisions of the original agreement of November 1, 1952. Under this oral agreement, Signal did bill taxpayer for the natural gasoline, but the transaction did not stop there. Signal then solemnly deducted its charge of 2½ cents per gallon and returned the balance to taxpayer. (R. 30, Exs. 8-A, 8-B, 8-C, 8-D, R. 205-210.) All that this transaction amounted to, therefore, was that instead of permitting Signal to sell the natural gasoline to third parties and deduct 2½ cents per gallon, taxpayer used the natural gasoline itself and paid Signal 2½ cents per gallon for processing it.

Apart from the obvious desire of the parties to do everything possible to make the transaction look like a sale, the reason for this strange procedure for the handling of natural gasoline is perfectly obvious. Taxpayer used the natural gasoline in its Bakersfield refinery, but was able to save the cost of transporting it to the refinery by virtue of an exchange agreement with Standard Oil Company of California under which it delivered the gasoline to Standard Oil in Los Angeles and received an equivalent quantity of the same product in Bakersfield. (R. 22, 206.) After the contract of November 1, 1952, Signal merely delivered the natural gasoline to Standard Oil Company for taxpayer's account. (R. 30, 256.)

The true nature of the relationship between taxpayer and Signal and the effect of the transaction of November 1, 1952, is illustrated by the testimony of taxpayer's president, Mr. Aubert. After testifying as to the operation of the exchange agreement just described, Mr. Aubert testified as follows (R. 256):

Q. After you sold your plant in Signal Hill to Signal Oil and Gas Company, how did you get your natural gasoline in Bakersfield?

A. The same way: We asked Signal if they could deliver the natural gasoline to Standard—I mean, we bought the gasoline from Signal, and then instructed Signal to deliver the natural gasoline to Standard for our account. Standard then delivered the natural gasoline to us in Bakersfield.

* * * *

The significance of this testimony is immediately apparent. It is evident that Mr. Aubert forgot himself and admitted that Signal did not own the natural gasoline which it processed, for, as he states, even after the transaction of November 1, 1952, all that taxpayer had to do was to tell Signal to deliver natural gasoline to Standard Oil under the exchange agreement. Realizing what he had said, Mr. Aubert hastily attempted to correct himself, and, referring to the oral agreement of November 1, 1952, stated that taxpayer purchased the natural gasoline from Signal and then told Signal where to deliver it. We have already seen that this nominal purchase was a pure fiction and that the only effect of that transaction was that Signal was paid 2½ cents per gallon for processing natural gasoline. The testimony of Mr. Aubert abundantly demonstrates that any attempt to treat the processing contract of November 1, 1952, as a sale of the producers' agreements must be dismissed as pure sham. Under that contract Signal owned nothing but the right to process wet gas and to receive processing charges therefor. It did not own the pipelines from the producers, it did not own the product resulting from processing, nor did it assume any of taxpayer's obligations under the contracts which it has purportedly purchased.

Lest there be any doubt upon this point, we need only look to taxpayer's own view of the transaction as reflected in its books of account. In those books, as demonstrated by a journal voucher attached to the stipulation of facts (Ex. 8-A, R. 205-208), taxpayer treated Signal's sales of the products derived from processing as sales of its own products, and the amounts deducted by Signal were treated as processing charges for natural gasoline and liquid propane. While the entries in such books constitute evidence which is entitled to considerable weight, it is not, of course, conclusive. *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179. The Commissioner does not here contend that the entries are conclusive, but he does assert that the absence of any satisfactory explanation for those entries demonstrates that they correctly reflect the true nature of the transaction as contemplated by the parties. In the Tax Court, taxpayer immediately recognized that these entries on its books were inconsistent with its theory of the case and therefore claimed that the entries were erroneous. (R. 42, 222.) It relied on the testimony of Mr. Harrell, a certified public accountant, who was also the vice-president of taxpayer. Mr. Harrell testified that he did not examine the contracts before determining the manner in which the entries should be made on the books. He stated that he was informed by Mr. Aubert, taxpayer's president, that the producers' contracts had been sold to Signal which, after November 1, 1952, would process the wet gas, but that taxpayer would continue to be obligated to pay the royalties to the producers. In view of these facts, according to Mr. Harrell, he set up the entries in taxpayer's books which showed the finished products as belonging to taxpayer and the sales thereof were shown as taxpayer's sales of its own finished products, less processing charges thereon. This was done, he testified, in order to show the gross proceeds or gross value of the products for purposes of accounting to the producers. (R. 266-268.) The same treatment was accorded the sales proceeds on taxpayer's tax return for 1952. (R. 36.)

Conceding that taxpayer owed a duty to the producers to account for the gross value of the processed gas in order to enable them to determine the royalties due, this does not explain why such gross value had to be set up as the value of products owned by taxpayer if the products were already owned by Signal. Nor does it explain why the entries showed the gross value of the products less Signal's processing charges, which were certainly a matter of complete indifference to the producers. The Tax Court correctly evaluated this phase of the controversy when it stated (R. 42-43):

> It is observed that Harrell's testimony offers no explanation as to why, if the contracts had been sold to Signal as he stated he had been advised, he, as a certified public accountant, found it either necessary or desirable to formulate an accounting procedure indicating the contrary merely in order to compute the amounts due the producers under their respective contracts.

The only explanation which may rationally be drawn is that the books did show the sales as sales by taxpayer of its own products because those were the true facts.

Lastly, we cannot overlook the fact that taxpayer was fully aware, at least as early as December 1, 1952, that the processing contract of November 1 of that year might not qualify as a sale or exchange of a capital asset. After communicating its concern to Signal, the latter agreed to indemnify taxpayer in the event that the latter should be required to pay tax on the $85,000 at more than capital gains rates. (R. 28-29; Ex. 5, R. 188.) This agreement, it would seem, supplies the motive for the entire transaction and the key to its solution. Taxpayer had valuable contracts with the producers giving it a supply of rich gas but it no longer wished to process such gas itself; having determined to allow Signal to do such processing, it was quickly realized that a mere contract which would employ Signal as the processor, a contract for which Signal was willing to pay, would merely result in the receipt of ordinary income. Cf. *General Artists Corp.* v. *Commissioner*, 17 T. C. 1517, affirmed, 205 F. 2d 360 (C. A. 2d), certiorari denied, 346 U. S. 866. Hence, it was decided that Signal would compensate taxpayer for the reduced income it would receive by permitting Signal to process the wet gas at high processing charges, but that the compensation would be cast in the form of a purchase of the producers' contracts for tax purposes. Even after this was done, however, it is manifest that taxpayer lacked confidence in the eventual success of the arrangement, and therefore demanded that Signal extend to it this additional indemnity in the event that taxpayer was taxed at more than capital gains rates.

This explanation is consistent with the entire transaction. It may be suggested, however, that if this theory be correct, why was Signal willing to pay $85,000 for a contract under which it was to perform work for which it was to be compensated? The answer is clear: Under the contract Signal was to receive processing charges of 2½ cents per gallon on natural gasoline and 1¼ cents per gallon on liquid propane, when the going rate for such processing was only approximately ¾ of a cent per gallon of natural gasoline. (R. 32, 241.) Signal paid $85,000, therefore, for the privilege of obtaining a contract under which it would receive three times the normal processing charge for natural gasoline and for a contract which was not terminable on short notice, as was customary. Signal did not suffer financially from this arrangement because, as the Tax Court noted, it amortized the $85,000 as the cost of the contract (R. 32), and in addition recouped that amount by the excess of the agreed processing charges over the customary charges.

The factors summarized lead inescapably to the conclusions that the entire transaction under review was not a sale of anything, but was merely an arrangement whereby Signal was employed by taxpayer to process wet gas under a contract which was so favorable to Signal that it was willing to pay a cash consideration for the privilege. The amount taxpayer received from Signal, however, was not paid on the sale or exchange of a capital asset for no capital asset was sold; it constituted compensation which must be taxed as ordinary income. As the Tax Court aptly stated (R. 43):

> From a consideration of all of the evidence bearing on the character of the transaction of November 1, 1952, between petitioner and Signal, we are of the opinion that the total effect or substance of the transaction was merely an arrangement whereby petitioner employed Signal for at least a period of 10 years and at a fixed or determinable compensation to perform a portion of the work or services required of petitioner by the eight producers' contracts and which portion the petitioner theretofore had performed. * * *

This case in many respects presents a striking analogy to the situation considered by the Court of Appeals for the Fourth Circuit in *Hamme* v. *Commissioner*, *supra*. In that case the taxpayers executed leases of mineral lands, then two years later "bargained and sold" the lands to the lessee in fee simple, subject to the condition that the lessee would pay royalties as provided in a contract of the same date and, in the event of default, that the lessee would reconvey the lands to the taxpayer. Notwithstanding the use of words of sale and of termination of ownership, the court in that case held that the substance of the transaction was nothing more than a lease and that the amounts received were taxable as ordinary income. In the present case, as in *Hamme*, the true substance of the transaction which emerges is that there was no sale, despite all attempts of the parties to use language which might indicate a sale. Since we must look to the substance and not to the form employed (*Commissioner* v. *P. G. Lake, Inc.*, 356 U. S. 260), it must be concluded that there was no sale or exchange of the producer contracts here in question and that the $85,000 received was, as the Tax Court held, properly taxable as ordinary income.

B. *Taxpayer did not sell a thirty percent interest in the contracts with the producers*

In the Tax Court, taxpayer relied upon the contentions discussed by that court and by the Commissioner in the preceding portions of this brief, namely, a sale of its entire interest in the producers' contracts. In the argument portion of its brief in this Court, however, taxpayer refers to this theory in only one paragraph. (Br. 24.) The balance of its argument is devoted to the contention that the parties kept their books on the basis of a sale of a thirty percent interest in such contracts to Signal and that, if taxpayer is bound by the Tax Court's findings, it is entitled to capital gains treatment on the $85,000 payment, but not on the amount of $11,-351.41, on the theory of a sale of a thirty percent interest. In its summary of argument and conclusions (Br. 19, 30), on the other hand, taxpayer refers to the thirty percent theory as an alternative argument. It will therefore be discussed herein on that basis, namely, an alternative argument which has been advanced in this Court for the first time in this proceeding.

It is well settled that an appellant may not raise issues is the appellate court which he had not argued in the court below. *Hormel* v. *Helvering*, 312 U. S. 552. Taxpayer cannot go to trial on one theory and then, when unsuccessful, seek to upset the trial court's determination on review upon a ground not presented to it. Taxpayer should, therefore, not be heard at this time to contest the Tax Court's decision upon a new ground not previously urged. At best, he is entitled to no more than a remand of the case in order to enable the Tax Court to consider this issue. A remand, however, would appear to be a futile gesture in the present situation, since the Tax Court's decision is clearly correct, as noted below.

Moreover, taxpayer's attempt to argue this point for the first time in his brief is in direct violation of Rule 17(6) of the Rules of this Court which requires taxpayer to file a statement of the points on which he intends to rely and provides that this Court "will consider nothing but * * * the points so stated." Taxpayer's petition for review (R. 46-54) filed August 22, 1958, contains a statement of numerous points on which it intends to rely, and taxpayer subsequently, on September 12, 1958, filed a statement of points adopting the prior statement filed (R. 279.) In neither of these documents, however, is any reference made to an argument that the transaction in question constituted a sale of a thirty percent interest, and such argument should not be permitted to be advanced at this stage of the proceedings.

Even if we examine the argument on its merits, it is obvious that taxpayer's assertion that the $85,-

000 was paid only for the sale of a thirty percent interest in the producers' contracts is an afterthought created out of thin air. It is an argument which plainly contradicts taxpayer's main position, for the contract itself plainly states that Signal agrees to pay $85,000 for the "gas contracts or other purchase agreements" held by taxpayer. (R. 24, 182.) There is nothing contained therein which refers to thirty percent of such contracts or agreements. Moreover, taxpayer argued in the court below, in an attempt to make the transaction into a sale, that the sales price was $85,000 plus the net proceeds of the products resulting from the processing of wet gas. His thirty percent sale theory requires an abandonment of that argument, because under that theory Signal paid $85,000 for the privilege of receiving the amount of 2½ cents per gallon on natural gasoline and 1¼ cents per gallon on liquid propane. This figures out to a thirty percent purchase, says taxpayer, because 2½ cents is thirty percent of the stipulated price of 8.33 cents, the price used as the basis for computing the deductions due Signal. (R. 25.)

The short answer to this entire argument is that there is not a shred of evidence which indicates that taxpayer was purchasing a partial interest in the producers' contracts, nor is there any indication of such a transaction in the contract itself, in the records kept by the parties or in their operations. It is noteworthy that if this theory be adopted, the amount of $11,351.41 received in 1952, on which taxpayer also claims capital gain treatment, and the amounts received in succeeding years as the net proceeds from the sale of processed gas, admittedly become proceeds from the sale of taxpayer's own product and could not be treated as capital gains. It is apparent that taxpayer has made this argument in a feeble attempt to salvage something from the adverse decision of the Tax Court.[3]

Taxpayer is in error when it states (Br. 24) that the parties have treated the transaction on their books and in their tax returns as a sale of a thirty percent interest. There is no evidence to support this bare assertion. Signal's books and returns are not before the Court, and taxpayer's books and 1952 tax return, which are in the record (Exs. 6, 8-A, R. 189, 205-208), do not contain any evidence of a sale of any interest, thirty percent or otherwise. The books, as has been noted, treat the products derived from the processing of wet gas as taxpayer's own, thus negating any sale entirely; the tax return, as has also been noted, merely refers to a sale of the processing plant, oil leases and tank farm for $135,000, without mentioning the producers' contracts. This can hardly be deemed evidence of a sale of a thirty percent interest. The fact that Signal may have amortized the $85,000 and may have treated the proceeds remitted to taxpayer as royalties, as

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[3] Taxpayer's citation of cases involving partial assignments of patents (Br. 26) is wholly inapposite. Such cases merely hold that a partial interest in a patent, that is, one limited to a particular geographic area or a particular industry, are *pro tanto* complete assignments of the patent. The citation of these cases here, however, merely begs the question whether such a partial assignment was ever made.

taxpayer suggests (Br. 13, 25), does not help taxpayer, for such treatment is consistent with a lease, or with a mere employment contract for processing, under which only the actual processing charges are includible in gross income. To the extent that Signal's books may have included the total proceeds in gross income, it is entitled to deduct the amounts belonging to taxpayer and remitted to it, thus leaving as taxable income only the processing charges received. It is hardly consistent with a sale for the purchaser to retain only a small processing charge and to remit the entire balance of the sales proceeds to the seller as "royalties".

Finally, taxpayer's theory of a sale of a thirty percent interest runs aground on the shoals of simple arithmetic. He premises the argument upon the fact that Signal's contract deduction was 2½ cents per gallon which is thirty percent of the assumed price of 8.33 cents per gallon. (Br. 24.) But, as we note from Exhibit 8-A (R. 205-208), the price of gasoline in November and December, 1952, was 10.28 cents and Signal's charge was 3.25 cents which is almost 32 percent of the price of the gasoline. Taxpayer can hardly argue that Signal bought a fluctuating percentage interest, the quantum of which varied with the market price of natural gasoline.

Under taxpayer's eight contracts with the producers and before the contract of November 1, 1952, taxpayer obtained the wet gas from the producers' wells, processed it and sold or retained for its own use the resultant natural gasoline, liquid propane and dry gas using the proceeds to pay the royalties due the producers and retaining the balance. After the processing contract with Signal on November 1, 1952, taxpayer still obtained the wet gas from the producers' wells and received the proceeds from the resultant products, using the proceeds to pay the royalties due the producers and retaining the balance. Signal was substituted for taxpayer in processing the wet gas and in selling it, but taxpayer continued to receive the proceeds. As the Tax Court correctly described the situation (R. 40):

> * * * it is clear that on and after November 1, 1952, the petitioner performed part of the work or services required under the producers' contracts and Signal performed part of such work or services, with petitioner performing the initial and final portions and Signal performing the intermediate portion.

The only change which was effected by the transaction of November 1, 1952, was that taxpayer paid Signal (or permitted it to deduct) a processing charge in lieu of performing the processing operation itself. This can hardly be described as a "sale" of the producers' contracts to Signal, or even a "sale" of a thirty percent interest therein. The transaction was merely an employment arrangement whereby Signal was retained as the processor for a specified fee. As the Tax Court properly stated, however, (R. 43): "arrangements whereby one is engaged to render services to or for another are not capital assets." The proceeds of such arrangements are not derived from the sale or exchange of capital assets and must therefore be taxed as ordinary income. The sum of $85,000 paid to taxpayer by Signal for entering into such an arrangement was merely a payment made to taxpayer to compensate it for the reduced proceeds it would receive by reason of having to pay Signal's high processing charges and to compensate it for awarding the contract for such processing to Signal; the Tax Court was therefore clearly correct in holding such sum taxable as ordinary income.

II

The Sum of $11,351.41 Received By Taxpayer from the Sales Proceeds of the Processed Gas Was Also Properly Included In Ordinary Income

In the same single paragraph of its argument in which it refers to a sale of the entire interest in the producers' contracts (Br. 24), taxpayer claims it is also entitled to capital gains treatment on the sum of $11,351.41, which represents the net proceeds retained by taxpayer in the months of November and December, 1952, from the processing of wet gas and the sale of the resultant products. When it proceeds to the alternative theory of a sale of a thirty percent interest, however, taxpayer expressly concedes (Br. 24) that it is "not entitled to the capital gains treatment" on the sum of $11,351.41. In view of this concession, therefore, we need discuss the proper tax treatment of the sum of $11,351.41 only in the original theory advanced by taxpayer, namely that there was a sale by taxpayer of its entire interest in the producers' contracts.

What has been said in the preceding portions of this brief, in discussing whether the processing contract of November 1, 1952, was a sale of taxpayer's entire interest in its contracts with the producers and whether taxpayer was entitled to capital gains treatment on the $85,000 received, is applicable with equal force to the sum of $11,351.41 here under discussion. If there was no sale and the sum of $85,000 therefore did not represent the sale price for taxpayer's entire interest in the producers' contracts, surely the $11,351.41 retained by it from the sales proceeds of processed gas could not be deemed part of a non-existent sale price either. On this aspect of the matter, moreover, the lack of substance to taxpayer's theory of a sale of its interest in the producers' contracts becomes more readily apparent.

Under the processing contract of November 1, 1952, Signal, as we have seen, "sold" the natural gasoline to taxpayer and sold the propane and dry gas to third parties. (R. 30-31.) From the proceeds thus derived, Signal first deducted its agreed charges of 2½ and 1¼ cents per gallon on natural gasoline and liquid propane, respectively, and remitted the balance to taxpayer, which then paid its royalty obligations to the producers and retained the balance for itself. In the two months of 1952, during which the processing contract with Signal was in operation, taxpayer realized the sum of $11,351.41.[4]

Taxpayer thus received what it had been entitled to receive before its contract with Signal—the net

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[4] As may be noted from the Tax Court's findings, taxpayer similarly realized $94,489.74 for the year 1953, $91,002.85 for the year 1954, and $90,465.43 for the year 1954. (R. 34.)

profit realized from the sale of the processed gas in its various forms. If the wet gas or processed gas remained taxpayer's property until sold to third parties, such net profit became merely the net profit from the sale of stock in trade, inasmuch as taxpayer clearly was engaged in the business of selling processed gas in its several forms.[5] We have noted that nowhere in its brief does taxpayer assert that the wet gas or processed gas became Signal's property. It properly refrains from doing so in view of the evidence that such gas was processed and sold for taxpayer's own account. Even as to the natural gasoline which Signal ostensibly "sold" to taxpayer under the oral agreement of November 1, 1952 (R. 22-28, 203-204), the evidence shows that Signal deducted its charge of 2½ cents per gallon from the amount paid by taxpayer and promptly remitted the balance to taxpayer (R. 30, Ex. 8-A, R. 205-208). In view of the evidence that the sales of processed gas were carried on its books as taxpayer's own sales (R. 41-42) and reported as such for income tax purposes (R. 36) and that taxpayer, as Mr. Aubert, its president, testified (R. 256), merely directed Signal to deliver the natural gasoline to Standard Oil Company under taxpayer's exchange agreement, it is apparent that neither the wet gas nor the processed gas ever became Signal's property.

Since it appears that taxpayer did not intend to, and did not, sell its entire interest in the contracts

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[5] The natural gasoline was sold in the form of blended gasoline after passing through taxpayer's refinery. (R. 21-30.) It thus remained part of taxpayer's stock in trade.

with the producers to Signal, but merely employed Signal to process the wet gas which taxpayer received, it is apparent that the sum of $11,351.41, the net proceeds realized from the sale of natural gasoline, liquid propane and dry gas in 1952, represented merely taxpayer's profits from the sale of its stock in trade. As such it is taxable as ordinary income, as any other merchant's sale of inventory. If taxpayer presses its alternative theory that there was a sale of a thirty percent interest in its producers' contracts, then concededly the $11,351.41 was not part of the sales price, but represented the profit derived from the seventy percent interest in the products retained by taxpayer. Under either theory, therefore, taxpayer is not entitled to capital gains treatment on that sum.

CONCLUSION

The decision of the Tax Court was correct and should be affirmed.

Respectfully submitted,

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